

Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **201208030**

Release Date: 2/24/2012

CC:ITA:B05:WLCandler
POSTU-108729-11

UILC: 61.28-03, 61.28-00

date: October 28, 2011

to: Candace M. Williams
Attorney (Dallas)
(Large Business & International)

from: John M. Aramburu
Senior Counsel, Branch 5
(Income Tax & Accounting)

subject:

This Chief Counsel Advice responds to your request for assistance dated .
This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Holding Corp =
Subsidiary =
Creditor =
Agreement =
Opinion =

Successor Corp =
Event =

Entities =
Party A =

Specified Actions =

Undertake
Certain Activities =

Date A =
Existing =
Requirements
Certain Practice =

Amount

Adjustments =

Pursuant to
Code Sections A and B

New Requirements =
New Requirements2=
Note =
Number =

\$A =
\$B =
\$C =
\$D =
\$E =
\$F =
\$G =
\$H =
\$I =
\$J =
\$K =
\$L =

W% =
X% =
Y% =

Year 1 =
Year 2 =
Year 3 =
Year 5 =
Year 6 =
Year 8 =

Year 9 =

ISSUE

Whether damages received as a result of the Event should be treated as ordinary income or as a return of capital to the extent of adjusted basis in stock (and gain to the extent in excess of basis).

CONCLUSION

The damages are fully taxable as gain, as Taxpayer should have recovered any basis in the transferred equity interest in a prior sale or exchange.

FACTS

In Year 1, Holding Corp, a company owned entirely by Taxpayer, acquired the assets and liabilities of Number Entities. The Entities were merged into a single entity, which was renamed Subsidiary. Pursuant to agreements between Taxpayer and Party A, Taxpayer and Holding Corp agreed to invest \$A in cash into Subsidiary. In return, Party A promised Specified Actions. The “Specified Actions” allowed Subsidiary to Undertake Certain Activities.

In Year 1, Taxpayer made an initial investment of \$C in Subsidiary, as required. Of this amount, \$D was a capital contribution made by Taxpayer with funds borrowed from an entity owned by Creditor. The remaining \$E was subordinated debt.

On Date A, the Event occurred. This changed Existing Requirements. Among other changes, it prohibited a Certain Practice. As a result, Subsidiary’s Amount decreased by \$E and fell below the New Requirements. In addition, Taxpayer’s agreement with Party A obligated the taxpayer to make investments of \$F in each of the years Year 2 and Year 3. Taxpayer was thus required to find new sources of financing.

Entities related to Taxpayer borrowed funds from entities related to Creditor (Creditor group). By Year 5, the amount owed to Creditor group had increased to some \$G. In Year 6, Taxpayer, certain related entities, and Creditor group entered into the Agreement, which restructured the debt. The debt was reduced to some \$H, and it was converted into longer-term financing. In exchange, Taxpayer agreed to give Creditor group an X% interest in Holding Corp and a right to share in the proceeds of any disposition of Subsidiary.¹

¹ At some point Holding Corp was renamed Successor Corp. Whether the profits interest was in Holding Corp or any successor does not affect our analysis.

Also, note that Taxpayer retained the right to receive \$K prior to having an obligation to share profits. This amount corresponds approximately to the amount of Taxpayer’s direct or indirect capital contribution to Subsidiary.

In Year 8, Taxpayer and certain related Entities filed suit against Party A, alleging that the Event's change in Existing Requirements was a breach of contract, specifically Party A's agreement to provide "Specified Actions." The court agreed with Taxpayer, and held that the New Requirements² increased Taxpayer's financing costs. After a series of appeals and remands, the United States Court of Appeals upheld a damages award to Taxpayer of \$I. Opinion. The award was paid in Year 9.

The award represents the additional financing costs incurred by Taxpayer as a result of the Event. The courts compared the cost of financing given the breach with the costs that would have been incurred had there been no breach. The courts concluded that in the latter case, Taxpayer would have transferred only Y% of Holding Corp to Creditor group in order to obtain necessary financing. As a result of Party A's breach of contract, however, the required transfer of equity rose to X%.² The damages award of some \$J reflects the value of the additional equity transferred to Creditor reduced by the value of the favorable long-term financing obtained because of the transfer.

LAW AND ANALYSIS

With respect to damages, "whether a claim is resolved through litigation or settlement, the nature of the underlying action determines the tax consequences of the resolution of the claim." Milenbach v. Commissioner, 106 T.C. 184, 198 (1996), aff'd in part and rev'd in part, remanded, 318 F.3d 924 (9th Cir. 2008) (quoting Tribune Publ. Co. v. United States, 836 F.2d 1176, 1177 (9th Cir. 1988)). In characterizing a settlement payment for tax purposes, we ask: "In lieu of what were the damages awarded?" Id. (quoting Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110, 113 (1st Cir. 1944), affg., 1 T.C. 952 (1943)).

When a court has entered a judgment for the taxpayer, the tax treatment of the taxpayer's recovery can be determined based on the taxpayer's complaint and issues and evidence presented to the jury. See, e.g., State Fish Co. v. Commissioner, 48 T.C. 465 (1967), modified by 49 T.C. 13 (1967), acq., 1968-2 C.B. 1. To the extent a recovery compensates for injury or loss to a taxpayer's property, it is considered to represent a restoration of capital to the extent of the taxpayer's capital interest. See § 3.01 of Rev. Proc. 67-33, 1967-2 C.B. 659; see also Rev. Rul. 81-277, 1981-2 C.B. 14 (treating buyer's recovery of damages from contractor for additional construction costs to correct construction defects as return of capital).

Taxpayer contends the damages are compensation for the taxpayer's transfer of an equity interest in Holding Corp and are taxable as gain only to the extent they exceed the taxpayer's basis in Year 9, in a successor to Holding Corp. Accordingly, Taxpayer

² The appellate court upheld the trial court's finding that had there been no breach, the taxpayer would have had to have given Holding Corp a Note in consideration for Holding Corp's assumption of the taxpayer's indebtedness to a Creditor entity. This would have increased the value of Holding Corp and reduced the percentage of ownership that needed to be conveyed to the Creditor group to Y%.

reported \$L of capital gain and treated the remainder of the recovery as a return of capital.

Yet, because Taxpayer, in Year 6, transferred an equity interest in Holding Corp to the Creditor group pursuant to the Agreement, none of the damages represent a return of capital. The equity interest was transferred in a sale or exchange within the meaning of section 1001 of the Internal Revenue Code. In return for the equity interest, the Taxpayer and the taxpayer's entities had their debt restructured, with both a reduction in the amount of the debt and an extension of its maturity. Inasmuch as Taxpayer received consideration for the Taxpayer's transfer, the transaction was an exchange. See La Rue v. Commissioner, 90 T.C. 465, 483 (T.C. 1988) ("The touchstone for sale or exchange treatment is consideration. If, in return for assets, any consideration is received, even if nominal in amount, the transaction will be classified as a sale or exchange."). Because the interest was transferred in a sale or exchange, any basis in the transferred interest should have been recovered at that time, in computing Taxpayer's capital gain or loss in the transaction. I.R.C. § 1001(a). Whatever basis Taxpayer had in the equity the taxpayer *retained* and whatever adjustments to basis in the retained interest were proper after the transfer, e.g., Adjustments Pursuant to Code Sections A and B, are immaterial.

This case is unlike those in which the taxpayer has an asset that is damaged or lost and subsequently there is compensation through litigation. In those cases, the taxpayer's asset is converted into cash only because of the recovery, and a basis offset is appropriate in measuring gain. One such case is Raytheon Production Corp. v. Commissioner, 144 F.2d 110 (1st Cir. 1944):

But, to say that the recovery represents a return of capital in that it takes the place of the business good will is not to conclude that it may not contain a taxable benefit. Although the injured party may not be deriving a profit as a result of the damage suit itself, the conversion thereby of his property into cash is a realization of any gain made over the cost or other basis of the good will prior to the illegal interference. Thus A buys Blackacre for \$5,000. It appreciates in value to \$50,000. B tortiously destroys it by fire. A sues and recovers \$50,000 tort damages from B. Although no gain was derived by A from the suit, his prior gain due to the appreciation in value of Blackacre is realized when it is turned into cash by the money damages.

Id. at 114. In this case, Taxpayer received consideration in Year 6, pursuant to the Agreement, and that was the time for recovering basis in measuring gain or loss.

Nor is this case like those in which a taxpayer incurs a cost because of another party's actions and thereafter recovers the cost through litigation. In those cases, the taxpayer incurs a cost without receiving any consideration in return, and the recovery of the cost is simply a return of capital. This is illustrated by Rev. Rul. 81-277, 1981-2 C.B. 14.:

In the present situation, the effect of the settlement agreement was that M would compensate P for M's failure to provide a fully operational and licensable plant for 250x dollars as agreed upon under the contract. The payment from M to P of 40x dollars represents the estimated present damages P has incurred because of the breach of contract, determined under the settlement agreement as the estimated additional costs needed to satisfy new regulatory standards that were necessary to deliver a complete, safe, licensable, fully operational plant as required under the contract. P has received no economic gain as a result of the 40x dollars payment and is merely being made whole under the contract. P is being restored to the position that it would have been in if M had fulfilled the terms of the contract.

In this case, the taxpayer did not simply incur a cost. Rather, the taxpayer transferred the equity interest pursuant to an agreement in which the taxpayer received *quid pro quo* consideration. The recovery of capital authorities upon which Taxpayer relies do not involve costs incurred pursuant to agreements providing for consideration. Under these circumstances, the costs are recovered in computing section 1001 gain or loss.³

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-4960 if you have any further questions.

³ We understand that payments to the Creditor group pursuant to the agreement to share profits were reported as deductible interest, although Taxpayer now confirms that the taxpayer transferred an equity interest to the Creditor group. If the agreement to share profits is treated as a requirement to pay additional interest, the damages recovery should be viewed as reimbursement for that obligation. Under the tax benefit rule, Taxpayer would be required to report ordinary income to the extent the taxpayer is reimbursed for amounts deducted in prior years. Weyher v. Commissioner, 66 T.C. 825 (1976).